

# **PAYING THE PRICE FOR TOO BIG TO FAIL**

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*“[W]e reiterate our determination to preserve the viability of systemically important financial institutions so that they are able to meet their commitments.”<sup>1</sup>*

## **I. INTRODUCTION**

We find ourselves in an economic crisis, the severity of which few persons living today have witnessed. Fear, the natural accompaniment of such crises, arises from our uncertainty about the depth and duration of the crisis. The consensus is that a restoration of confidence is fundamental to a recovery. From the eye of the storm, it is difficult to assess the effectiveness of attempts at quelling its ravages. Yet, we may have little choice but to begin making those assessments as the architecture of the new order is being designed now.

The origins of the current crisis are well recorded.<sup>2</sup> Topping the list of causal factors were a U.S. obsession with housing creation, unnaturally low interest rates, deregulation of financial and capital markets, a blind eye by policymakers to correlation risks to the economy, financial engineering, accounting doctrine, and, of course, the standby for all economic emergencies, greed. One factor that pulled together elements of all of these was the presence of several large and complex financial institutions, each of whose disorderly liquidation would have a disastrous effect on the financial system and on the real economy. The threat posed by these institutions to the public interest caused them to be grouped under the misleading heading “too big to fail” (TBTF). The title is misleading on the one hand, because it implies that institutions are readily identified as

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<sup>1</sup> Press Release, U.S. Dep’t of the Treasury, Joint Statement by the Treasury, FDIC, OCC, OTS and the Federal Reserve (Feb. 23, 2009).

<sup>2</sup> See generally GARY H. STERN & RON J. FELDMAN, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS* (Brookings Inst. (2004)).

falling into this category, and, on the other hand, by the false signal that size alone matters when, in fact, other characteristics of a firm (complexity, leverage, interconnectedness) may be what creates the foreboding that spillover effects from a firm's demise will threaten the economy.

In its response to the current crisis, the federal government has been adding to the legacy of the inchoate TBTF policy of the U.S., and the picture has not been pretty and hardly inspiring of much needed confidence. The bailouts have been so arbitrary, so vague of purpose, and so poorly communicated that it is little wonder that neither consumers nor markets have been encouraged. The deficiency of policymakers' response to the current crisis has been well chronicled, and the purpose of this paper is not to add to that body of work. Rather, the attempt here is to set forth a new way forward for dealing with the systemically significant or, as grudgingly referred to below, TBTF firms. It will be pointed out that the current reactive policy of "constructive ambiguity" may well be ambiguous but is hardly constructive. In its place is suggested a more forward-looking approach that, before the crisis hits, defines and identifies institutions whose uninsured creditors will be protected. That protection comes at a cost, however, in the form of informational intimacy with the firms' constituents and with their regulators. Most significantly, what is called for is a transfer of the funding advantage such firms enjoy back from whence it came—the general treasury and the taxpayers.

This new approach, viewed from one perspective, is a radical departure from a century of U.S. democratic capitalism. From another perspective, however, it is a logical next step beyond those already taken by policymakers in response to the current economic crisis. It draws upon the historical lesson that government support of private institutions comes with a price, whether that support is explicit or implicit. If we are to tolerate the continued operation of legal entities whose very size and complexity pose a risk to the general economic welfare, then the market will identify those firms with some precision and their competitive advantage, already considerable due to their scale, will be magnified by the perceived backing by the government of their uninsured creditors.

## II. HOW WE GOT HERE

The causes and conditions that led to the current crisis have been amply documented. Soft and hard causes are common to many of these studies. Prominent soft causes identified in the studies are greed and moral hazard. Common hard causes are the increased size and complexity of financial services firms in recent decades. In the last three decades, consolidation and convergence among the firms that constitute what is customarily regarded as the financial services industry (banking, securities, and insurance) has produced several firms boasting assets exceeding \$1 trillion. The composition of the industry has become less bank-centric

during this period. In 2006, for example, of the twenty-five largest financial services firms by revenue, only six were primarily banking firms. By 2008, nine of the most prominent firms in the industry had either ceased to exist as independent companies or had changed their business models.<sup>3</sup> In 1997, the ten largest banks in the U.S. had 52.7 million deposit accounts. Ten years later, the single largest bank boasted fifty-four million deposit accounts.<sup>4</sup>

As if the challenge of managing a leap in the scope and the scale of these firms was not enough, during this same period there emerged an array of complex financial products, many of them with roots in the \$11 trillion mortgage market. Mortgage backed securities (government backed and private label), collateralized debt obligations, and credit default swaps, to name a few, became part of the product offerings at these firms. As we now know, these creative products were adopted without either: a) an understanding by management or boards of directors of how the products worked, or, b) an elementary risk management system to identify loss prevention measures and ameliorate the products' hazards.

Congress, policymakers and even the courts encouraged consolidation, convergence and financial engineering. In particular, Alan Greenspan, Chairman of the Federal Reserve Board during most of this period, applauded what he thought was the diversion of risk outside the supposedly highly-regulated banking system as though nonbanks were a form of landfill whose toxic contents could not leach back into the banking system or the economy.<sup>5</sup> Little note was taken of the burgeoning risks that were amassing in the off-balance sheet records of the largest institutions. When, either for contractual or reputational reasons, these losses were acknowledged, a massive hole had been created in the institutions' balance sheets and, just as importantly, in their credibility with investors and counterparties<sup>6</sup>—a credibility gap that continues.<sup>7</sup>

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<sup>3</sup> These are: AIG, Morgan Stanley, Merrill Lynch, Goldman Sachs Group, Lehman Brothers Holdings, Freddie Mac, Fannie Mae, Bear Stearns, and Countrywide.

<sup>4</sup> Notice of Proposed Rulemaking by FDIC on the Processing of Deposit Accounts in the Event of a Failure, 73 Fed. Reg. 2364, 2369 (proposed Jan. 14, 2008) (to be codified at 12 C.F.R. pt. 360).

<sup>5</sup> Peter Goodman, *Taking a Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A1.

<sup>6</sup> Days after Citigroup, Inc. appointed its newest CEO, Vikram Pandit, the bank took \$49 Billion in SIV assets onto its balance sheet. Eric Dash, *Big Rescue of Funds by Citigroup*, N.Y. TIMES, Dec. 14, 2007, at C1.

<sup>7</sup> Eric Dash, *Big Rescue of Funds by Citigroup*, N.Y. TIMES, Dec. 14, 2007, at C1 (reporting that days after Citigroup appointed its newest CEO, the bank took \$49 billion in SIV assets onto its balance sheet).

The refrain that the current crisis was “unpredictable” has worn thin.<sup>8</sup> In many respects, the crisis was not only predictable, it was unavoidable and foreordained by the very actors who are now downplaying their own powers of prophecy. Take the case of derivatives, the single most pervasive and toxic product that contributed to the crisis.

In 1997, Brooksley Born, then chair of the Commodities Futures Trading Commission (CFTC), attempted to bring derivative instruments under the regulatory jurisdiction of the CFTC.<sup>9</sup> She warned that unregulated trading could pose potentially serious dangers to the economy.<sup>10</sup> She called for greater transparency, and disclosure of trades and reserves, as a protection against losses.<sup>11</sup> She was not alone. Years earlier, the then head of the Government Accountability Office (GAO), Charles Bowsher, cautioned:

The sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in the markets and could also pose risks to others, including federally insured banks and the financial system as a whole... In some cases intervention has and could result in a financial bailout paid for or guaranteed by taxpayers.<sup>12</sup>

Messrs. Rubin, Summers and Greenspan thwarted Ms. Born's efforts.<sup>13</sup> A year later, disastrous bets on derivatives contributed to the collapse of Long Term Capital Management (LTCM) and the government orchestrated rescue described below.<sup>14</sup> Finally, in the fall of 2000, with the nation distracted by the *Bush v. Gore* saga and well after Ms. Born's resignation, Congress and the Clinton administration ensured that derivatives trading would not be threatened again by CFTC oversight by enacting the Commodity Futures Modernization Act.<sup>15</sup> Guiding this

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<sup>8</sup> Colin Barr, *The Questions Greenspan Didn't Ask*, CNNMONEY.COM, Apr. 11, 2008, <http://money.cnn.com/2008/04/10/news/newsmakers/greenspan.fortune/index.htm?postversion=2008041105>.

<sup>9</sup> Goodman, *supra* note 5, at A1.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> Goodman, *supra* note 5, at A1.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

legislation along its way to enactment was Treasury Undersecretary, and current CFTC chair nominee, Gary Gensler.<sup>16</sup>

On November 12, 1999, then President Clinton signed the Gramm Leach Bliley Act<sup>17</sup> culminating twenty years of lobbying effort, particularly by the banking and securities industries. The Act kick-started the convergence of the banking, securities and insurance industries—a process that was well under way at the time. Key to the Act’s passage was general agreement of all interested parties around the notion of “functional regulation.” Functional regulation assured the concerned industries that their regulatory relationships would be uninterrupted by the new law.<sup>18</sup> In sum, functional regulation froze in place regulatory roles and responsibilities as they existed on that date, notwithstanding the tectonic scale and scope shifts that were taking place in the financial services industry.

In a bow to the general awareness that something terribly important was happening in the financial markets, the Federal Reserve (Fed) was identified as the “umbrella regulator” without that term ever being mentioned in the law itself. This seeming banquet of regulatory responsibility was bestowed on the Fed along with the caution that it should rely on primary regulators to the extent possible.<sup>19</sup> A more alert Congress might have been reluctant to bestow this sweeping authority in light of the Fed’s having fallen down on its responsibilities under another important statute.

Congress enacted the Home Ownership and Equity Protection Act (HOEPA) in 1994<sup>20</sup> in response to evidence of a pattern of abuse in the subprime mortgage market. The Fed’s timid implementation of HOEPA squandered an opportunity to stunt the growth of the emerging subprime mortgage market.<sup>21</sup> It is not surprising, therefore, that its exercise of umbrella supervision was, until the current storm made landfall, timid as well. Not until 2008, well after the subprime mortgage market had shut down, did the Fed finalize its HOEPA rules.

Even a vigilant Fed would have had its hands full over the last decade in light of the risks to the financial system posed by a variety of firms well outside the shadow of its regulatory umbrella. Alternative investment vehicles (primarily hedge funds), ratings agencies, and mortgage brokers were churning out a variety of products and services on

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<sup>16</sup> Robert Scheer, *Obama’s Toxic Advisers*, THE NATION.COM, Mar. 25, 2009, [http://www.thenation.com/doc/20090406/scheer?rel=hp\\_picks](http://www.thenation.com/doc/20090406/scheer?rel=hp_picks).

<sup>17</sup> Gramm Leach Bliley Act of 2000, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, 108 Stat 2190 (1994).

<sup>21</sup> EDWARD M. GRAMLICH, *SUBPRIME MORTGAGES: AMERICA’S LATEST BOOM AND BUST* 28 (URBAN INST. PRESS 2007).

the periphery, but in plain view, of the financial services industry. Each of these industry sectors played a fundamental role in the lead up to the current crisis. It is now well accepted that any comprehensive plan to reform the regulatory system must include regulation of hedge funds, ratings agencies, mortgage brokers, and other actors in what has become known as the “shadow financial system.”<sup>22</sup>

It should surprise no one that a regulatory structure unable or unwilling to adapt to shifts in the industry has also proven itself inept at dealing with the current systemic crisis. Despite periodic warnings, overreliance on market discipline combined with a flawed regulatory system led to willful neglect of the problems bubbling beneath the surface.<sup>23</sup> Any one of the recent examples, including Continental Illinois, the savings and loan debacle, or LTCM, should have been sufficient notice that our tools and methods for dealing with too big to fail firms and industries were lacking. If nothing else, these events should have taught us the obvious lesson: “Once a crisis has arisen, financial regulation has already failed.”<sup>24</sup>

### III. ADDRESSING A SYSTEMIC CRISIS

Policy reactions to the current crisis have taken three forms: stimulus,<sup>25</sup> liquidity credit facilities,<sup>26</sup> and capital enhancements of specific institutions posing risk both to the financial system and to the real economy. It is difficult to assess what the long-term effects of intervention with Bear Stearns, AIG, Citigroup, Bank of America, Fannie Mae, and Freddie Mac, or the nonintervention with Lehman Brothers, will be. However, when measured against the goal of restoration of investor and public confidence, each has come up short.

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<sup>22</sup> CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM 23 (Comm. Print 2009).

<sup>23</sup> See ROBERT E. LITAN & MARTIN N. BAILY, BROOKINGS INST., *FIXING FINANCE: A ROADMAP TO REFORM* 18 (2009), available at [http://www.brookings.edu/~media/Files/rc/papers/2009/0217\\_finance\\_baily\\_litan/0217\\_finance\\_baily\\_litan.pdf](http://www.brookings.edu/~media/Files/rc/papers/2009/0217_finance_baily_litan/0217_finance_baily_litan.pdf).

<sup>24</sup> CONG. OVERSIGHT PANEL, 111TH CONG., *supra* note 22 at 22.

<sup>25</sup> See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009); Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (2008).

<sup>26</sup> A running update of the various facilities introduced and maintained by the Federal Reserve, Treasury and the FDIC can be found at the Morin Center for Banking and Financial Law website: [http://www.bu.edu/law/morincenter/lectures/documents/Crisis\\_Facilities\\_2-10-09copyforformatting.pdf](http://www.bu.edu/law/morincenter/lectures/documents/Crisis_Facilities_2-10-09copyforformatting.pdf). The update includes statutory authority, type of facility, expiration date and other useful information for each facility.

The legal authority is not always present for intervention with systemically significant institutions, and, when it is present, is not necessarily clear. Moreover, no one federal agency is clearly charged with the authority to act as a systemic regulator, thus forcing the major agencies and departments (Treasury, Fed, FDIC, FHFA, and SEC) to consult with one another. The result has been a series of *ad hoc* interventions that, taken together: 1) are inconsistent, 2) are expensive to taxpayers, 3) are inequitable, 4) are ineffective, and, 5) add to the dread that citizens and markets would like to move beyond.

In this paper, we will lay out exactly what the legal authority is for government intervention in favor of the uninsured creditors of TBTF institutions. Next, we will recap how that authority has been used and not used over the past thirty years with particular attention to the current crisis. The ensuing discussion will highlight that the difficulty with the current approach to systemically significant institutions is not just when to intervene, but how to do so, and to what end. For example, is the intervention designed to restore the TBTF institution to health, to buy time for its orderly dismemberment, or merely to keep it functioning so as to do no further damage to the real economy?

Utilization of the TBTF cudgel has produced a policy mosaic that is erratic and counterproductive. As a result, a consensus has been emerging that a new way has to be found for dealing with systemic risk. Although much of the debate has been around which agency should be responsible for carrying out the new policy, more serious studies and analysis have devoted more attention to the philosophical outlines of the new policy. In this regard, there seems to be overall agreement that, going forward, we have to: a) identify *ex ante* with specificity which institutions are systemically significant, and, b) regulate those institutions in a more rigorous way. This paper observes that the benefits of being identified as TBTF significantly outweigh the costs of even the most rigorous regulatory regiment. The net benefit to the TBTF firm is derived from the taxpayers and needs to be returned to the taxpayers in the form of an explicit price charged to the TBTF firm. It is this pricing element that needs to be introduced to the public dialogue about systemic risk and the TBTF firm.

#### IV. LAWS RELATED TO SYSTEMICALLY IMPORTANT FAILING FINANCIAL INSTITUTIONS

Throughout the years, legislation enacted for the different governmental organizations that oversee financial institutions reveals the government's position about the circumstances in which governmental intervention is warranted when a systemically significant financial institution is likely to fail. The Federal Deposit Insurance Corporation Act, the Federal Reserve Act, the Federal Deposit Insurance Corporation Improvement Act, the Housing Economic Recovery Act and the Emergency

Economic Stabilization Act are examples of this type of legislation. Each of these statutes includes provisions on the procedure and standards that the relevant governmental agency must follow when failing institutions warrant governmental intervention. The following is a summary of the applicable TBTF statutes and how the statutes have been utilized.

### *A. Federal Deposit Insurance Act*

The Federal Deposit Insurance Act of 1950 (FDIA) includes the basic authority for the operation of the FDIC.<sup>27</sup> FDIA consolidated all the earlier Federal Deposit Insurance Corporation's (FDIC) legislation into one Act and revised some other laws.<sup>28</sup> An important provision in the FDIA was Section 13(c)(2). This section, which was amended later, gave the FDIC bailout authority, when certain conditions were met.<sup>29</sup> The doctrine contained in this section was known as the "essentiality doctrine."<sup>30</sup> The relevant language of Section 13(c)(2) reads:

...when the Corporation has determined that an insured bank is in danger of closing, in order to prevent such closing, the Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of, or make deposits in, such insured bank, upon such terms and conditions as the Board of Directors may prescribe, when in the opinion of the Board of Directors the continued operation of such bank is *essential to provide adequate banking service in the community.* (emphasis added)<sup>31</sup>

The standards set by this section required (1) that there is a finding that the bank is in danger of closing,; and, (2) that the operation of the bank is essential to the community.<sup>32</sup> Neither the law nor the legislative history

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<sup>27</sup>FDIC, Important Banking Regulation, *available at* <http://www.fdic.gov/regulations/laws/important/index.html> (last visited Oct. 29, 2008).

<sup>28</sup>*Id.*

<sup>29</sup>IRVINE H. SPRAGUE, BAILOUT, AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES, 27-29 (1986).

<sup>30</sup>*Id.* at 87.

<sup>31</sup>Federal Deposit Insurance Act of 1950, § 13(c), 64 Stat. 873, 888-889 (1950) (current version at 12 U.S.C.S. § 1823 (2008)) (emphasis added).)

<sup>32</sup>Sprague, *supra* note 29, at 43.



provided any insight as to how these findings should be made.<sup>33</sup> Moreover, the law did not include the definition of community or adequate banking services.<sup>34</sup> Although when Congress passed the law it might have included the word community with a geographical sense, the word took on a broader meaning later: groups or constituencies that have common interests.<sup>35</sup> In practice, the FDIC was reluctant in making a finding of essentiality unless there was a “clear and present danger to the nation’s financial system.”<sup>36</sup> The law gave the FDIC Board of Directors discretionary authority to make the findings.<sup>37</sup> However, the statute required that at least two out of the three directors of the FDIC agree on the findings and the action to pursue.<sup>38</sup>

### B. *The Federal Deposit Insurance Corporation Improvement Act*

In 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which included provisions to address the TBTF problem.<sup>39</sup> Until 1991, the FDIC was required to estimate the cost of a payoff and liquidation as the standard of comparison and could adopt an alternative resolution if the alternative was expected to be less costly than the standard.<sup>40</sup> But when the FDIC operated under the essentiality provision, cost considerations could be disregarded.<sup>41</sup> FDICIA amended Section 13(c)(2), requiring regulators to close banks using the least-cost procedure, thus prohibiting the FDIC from granting open-bank assistance to a failing bank unless its action was cheaper than a closed-bank resolution.<sup>42</sup> The FDIC was required to use the *least* costly method of failure resolution, not just less costly.<sup>43</sup> As a result, this provision made it more “likely that uninsured depositors and creditors will suffer losses when

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<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 43.

<sup>36</sup> *Id.* at 28-29. The case of Unity Bank of Boston in 1971 is the exception. In that case, the FDIC made an essentiality finding based on the interests of the black community in Roxbury, a neighborhood of Boston.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 28-29. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 increased the FDIC’s Board of Directors to five members by adding a vice chairman position and the director of the newly formed Office of Thrift Supervision.

<sup>39</sup> Frederic S. Mishkin, *How Big a Problem is Too Big to Fail? A Review of Gary Stern and Ron Feldman’s Too Big to Fail: The Hazards of Bank Bailouts*, 44 J. ECON. LIT 988, 994 (2006).

<sup>40</sup> Lee Davison, *Continental Illinois and “Too Big to Fail”*, HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE 244 (FDIC 1997) [hereinafter *FDIC History*], available at [www.fdic.gov/bank/historical/history/235\\_258.pdf](http://www.fdic.gov/bank/historical/history/235_258.pdf).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Stern & Feldman, *supra* note 2, at 154.

a bank fails.”<sup>44</sup> However, there is an exception to the least-cost procedure.<sup>45</sup> The exception dictates that if the least-cost resolution presents “serious adverse effects on economic conditions or financial stability,” the FDIC can follow a different action to protect the uninsured creditors and thereby ameliorate the impact of bank failure on those same economic conditions and financial stability.<sup>46</sup> FDICIA established the following procedure: (1) at least two-thirds of the FDIC Board must agree to make a written recommendation to the Secretary of the Treasury that an exception to the least-cost procedure is warranted; (2) at least two-thirds of the Federal Reserve Board must also agree to make the same written recommendation to the Secretary of the Treasury; and, (3) upon receiving the recommendation, the Secretary of the Treasury, in consultation with the President of the United States, must determine that if the least-cost procedure was administered then there would be “serious adverse effects on economic conditions or financial stability.”<sup>47</sup> Once these conditions are met, the FDIC may act to avoid or mitigate those adverse effects.<sup>48</sup> The FDIC is allowed to use the Deposit Insurance Fund for an action under the systemic risk exception.<sup>49</sup> However, the FDIC can expeditiously recover the loss to the Fund, if any, from protecting insured claimants.<sup>50</sup> The recovery on behalf of the Fund must be made through an assessment on the total assets, equity and subordinated debt of all insured banks.<sup>51</sup>

### C. The Federal Reserve Act

The Federal Reserve Act (FRA)<sup>52</sup> contains, among other things, a description of all the powers awarded to Federal Reserve Banks. Traditionally, one of these powers has been to lend through a discount window. In the past, the Fed only loaned to commercial banks.<sup>53</sup>

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<sup>44</sup> Mishkin, *supra* note 39, at 994.

<sup>45</sup> 12 U.S.C. § 1823(c)(4)(G)(i) (2008). *See also* STERN & FELDMAN, *supra* note 2, at 78.

<sup>46</sup> 12 U.S.C. § 1823(c)(4)(G)(i) (2008).

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* (12 U.S.C. § 1823(c)(4)(E) establishes that the Deposit Insurance Fund cannot be used in connection with an insured depository institution that would have the effect of increasing losses to the Deposit Insurance Fund by protecting the depositors or creditors. However, 12 U.S.C. § 1823(c)(4)(G)(i) is outside that limitation.).

<sup>50</sup> 12 U.S.C. § 1823(c)(4)(G)(ii) (stating the recovery must be made according to an assessment on the total assets of all insured banks).

<sup>51</sup> *Id.*

<sup>52</sup> Federal Reserve Act of 1913, 12 U.S.C. § 221 (2000).

<sup>53</sup> David Fetting, Fed. Reserve Bank of Minneapolis, *Lender of More than Last Resort*, THE REGION, Dec. 2002, at 15, available at

However, in 1932, the Federal Reserve Act was amended to allow the Federal Reserve Board to make the discount window in the Federal Reserve Banks accessible to other financial institutions beyond commercial banks.<sup>54</sup> Section 13(3) of the FRA states:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange . . . [p]rovided, [t]hat before discounting... . . . the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions....<sup>55</sup>

The process outlined by the FRA requires: (1) the Board of Governors of the Fed to determine that the circumstances are unusual and exigent; (2) evidence that no other banking institution is willing to provide the credit; (3) at least five members of the Board of Governors of the Fed to give authorization; and, (4) the Board of Governors to authorize any Federal Reserve bank to discount the instruments of an individual, partnership, or corporation.

#### D. *Housing and Economic Recovery Act*

On July 30, 2008, in response to the subprime mortgage crisis,<sup>56</sup> the Housing and Economic Recovery Act of 2008 (HERA) was enacted.<sup>57</sup> One of the primary purposes of HERA was to reinforce and improve the regulation of the housing government-sponsored enterprises (GSEs),

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<http://www.minneapolisfed.org/pubs/region/02-12/lender.pdf.pdf>  
[publications\\_papers/pub\\_display.cfm?id=3392](http://www.minneapolisfed.org/pubs/publications_papers/pub_display.cfm?id=3392).

<sup>54</sup> 12 U.S.C. S. § 343 (2008). *See also* WALKER F. TODD, AM. INST. FOR ECON. RESEARCH, THE BEAR STEARNS RESCUE AND EMERGENCY CREDIT FOR INVESTMENT BANKS (Aug. 11, 2008), available at <http://www.aier.org/research/445-the-bear-stearns-rescue-and-emergency-credit-for-investment-banks?format=pdf>.

<sup>55</sup> 12 U.S.C.S. § 343 (2008).

<sup>56</sup> *See generally* David Messerschmitt et al., *Developments in Banking and Financial Law: 2006 - 2007: The Subprime Mortgage Crisis*, 27 REV. BANKING AND FIN. L. 1 (2008).

<sup>57</sup> Housing Economic Recovery Act of 2008, Pub. L. No. 110- 289, 122 Stat. 2654 (2008).

Freddie Mac and Fannie Mae, and the Federal Home Loan Banks.<sup>58</sup> To accomplish this goal, HERA established a new, independent regulator: the Federal Housing Finance Agency (FHFA), which phased out the regulator of Fannie Mae and Freddie Mac, the Office of Federal Housing Enterprise Oversight, and the regulator of the Federal Home Loan Banks, the Federal Housing Finance Board.<sup>59</sup> Under HERA, the FHFA has powers for prompt corrective action.<sup>60</sup> Within those powers, the FHFA can exercise control over “critically undercapitalized regulated entities.”<sup>61</sup>

One of the approaches that FHFA can take is conservatorship.<sup>62</sup> The purpose of placing the entity in conservatorship is to reorganize, rehabilitate, or wind up “the affairs of a regulated entity.”<sup>63</sup> According to Section 1145 of HERA, the Director of the FHFA has the discretion to appoint the FHFA as the conservator or receiver of one of these GSEs.<sup>64</sup> HERA lists twelve different grounds for making a discretionary appointment.<sup>65</sup> The grounds range from the entity engaging in money laundering to simply its consenting to the conservatorship.<sup>66</sup> HERA also gives the Director of FHFA the power to place the GSEs in mandatory receivership.<sup>67</sup> The decision to place an entity under receivership or conservatorship is reviewable only by a court.<sup>68</sup> Within thirty days of the Director’s decision to place a GSE in receivership or conservatorship, the entity can “bring an action in the United States district court for the judicial district in which the home office of such regulated entity is located, or in the United States District Court for the District of Columbia” to require the FHFA to remove itself as conservator or receiver.<sup>69</sup> The court has the power to dismiss the action or to direct the FHFA to remove itself from the

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<sup>58</sup> Press Release, U.S. Senate, Summary of the Housing and Economic Recovery Act of 2008 (June 20, 2008), *available at* [http://banking.senate.gov/public/\\_files/HousingandEconomicRecoveryActSummary.pdf](http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActSummary.pdf).

<sup>59</sup> *Id.*

<sup>60</sup> Housing Economic Recovery Act of 2008, Pub. L. No. 110- 289 § 1133, 122 Stat. 2654 (2008.).

<sup>61</sup> Housing Economic Recovery Act of 2008, Pub. L. No. 110- 289 § 1145, 122 Stat. 2654 (2008).

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* The twelve grounds listed in Section 1145 are: assets insufficient for obligations, substantial dissipation, unsafe or unsound condition, cease and desist orders, concealment, inability to meet obligations, losses, violations of law, consent, undercapitalization, critical undercapitalization and money laundering.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

position of conservator or receiver.<sup>70</sup>

Also, Section 1117 of HERA granted the Secretary of the Treasury authority until December 31, 2009, to buy obligations and other securities issued by GSEs, as long as the Secretary made a determination of emergency.<sup>71</sup> To make a finding of emergency, the Secretary of Treasury needs to determine that the actions are necessary to: “(i) provide stability to the financial markets, (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer.”<sup>72</sup> HERA does not limit the amount that the Treasury can purchase.<sup>73</sup>

#### E. *The Emergency Economic Stabilization Act*

On October 3, 2008, the President signed into law the Emergency Economic Stabilization Act of 2008 (EESA).<sup>74</sup> EESA was a radical move by the government of the United States to stabilize the financial system and protect the economic welfare of Americans.<sup>75</sup> EESA contains a provision for the “Troubled Asset Relief Program” (TARP).<sup>76</sup> EESA gave the Secretary of the Treasury not only authority to develop and implement the TARP program, but also discretion to determine the terms and conditions of the program.<sup>77</sup> EESA requires that the Secretary of the Treasury consult with the Fed, the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the National Credit Union Administration, and the Secretary of Housing and Urban Development as the Secretary exercises authority related to TARP.<sup>78</sup> EESA also authorizes the Secretary of the Treasury to take any action the Secretary considers necessary to perform his or her authorities under EESA.<sup>79</sup> Furthermore, the

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<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at § 1117 (amending Section 304 of the Federal National Mortgage Association Charter Act (12 U.S.C. § 1719 (2000)) and Section 306 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. § 1455 (2000))).

<sup>72</sup> *Id.* at § 1117.

<sup>73</sup> *Id.*

<sup>74</sup> David M. Herszenhorn, *Bush Signs Bill, N.Y. Rules*, NY TIMES, Oct. 4, 2008, at A1.

<sup>75</sup> Press Release, U.S. Dep’t of Treasury, Paulson Statement on Emergency Economic Stabilization Act (Oct. 3, 2008), *available at* <http://treas.gov/press/releases/hp1175.htm>.

<sup>76</sup> Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101(a), 122 Stat. 3765 (2008) (granting authority to the Secretary of the Treasury “to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary.”).

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at § 101(b).

<sup>79</sup> *Id.* at § 101(c).

Act requires the Secretary of the Treasury to publish program guidelines “[b]efore the earlier of the end of the 2-business-day period beginning on the date of the first purchase of troubled assets . . . or the end of the 45-day period beginning on the date of enactment of this Act.”<sup>80</sup> Finally, the Act establishes that the Secretary of the Treasury must take the necessary steps to prevent unjust enrichment by participating institutions.<sup>81</sup>

## V. APPLICATION OF THE LAW

The laws discussed above relate to the powers conferred to governmental agencies to respond to situations in which a financial institution's failure poses a significant risk to the economy. FDIA provided the essentiality doctrine, granting considerable discretion to the Board of Directors of the FDIC, only requiring a majority of the FDIC Board to agree on the essentiality finding.<sup>82</sup> FDICIA replaced the FDIA's essentiality doctrine with the least-cost requirement, and provided for the “systemic risk” exception.<sup>83</sup> FDICIA made the process more public by requiring the FDIC Board and the Fed to make a recommendation to the Secretary of the Treasury that the least-cost procedure should not be used. Then, the Secretary of the Treasury, in consultation with the President, was required to determine that utilizing the least-cost procedure would lead to “serious adverse effects on economic conditions or financial stability.”<sup>84</sup> FDICIA also granted considerable discretion to the FDIC, the Fed and the Secretary of the Treasury by not providing specific objectives as to how “serious” the adverse effects, or what the nature of the adverse effect on economic conditions of financial institutions, need to be. The FRA provides that in “unusual and exigent circumstances” the Fed's discount window (usually only available to commercial banks) could be available to anyone (including financial institutions and individuals) that the Fed authorizes.<sup>85</sup> The authorization must be made by at least five of the seven members of the Fed, and furthermore, it needs to be accompanied by evidence that no other banking institution is able to secure credit.<sup>86</sup> The FRA did not give the Fed clear guidance as to what “unusual” or “exigent” means within the context of the statute.

More recently, HERA gave the Director of FHFA broad discretion to place a critically undercapitalized entity in conservatorship or receivership, as long as the decision is supported by one of the twelve

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<sup>80</sup> *Id.* at § 101(d).

<sup>81</sup> *Id.* at § 101(e).

<sup>82</sup> Federal Deposit Insurance Act of 1950, § 13(c), 64 Stat. 873, 889 (1950) (current version at 12 U.S.C.S. § 1823 (2008)).

<sup>83</sup> Stern & Feldman, *supra* note 2, app. at 154.

<sup>84</sup> *Id.*; 12 U.S.C.S. § 1823(c)(4)(G)(i) (2008).

<sup>85</sup> 12 U.S.C.S. § 343 (2008).

<sup>86</sup> *Id.*

grounds provided in HERA.<sup>87</sup> Finally, EESA granted the Secretary of the Treasury expansive discretion to develop, implement and determine the terms and conditions of TARP.<sup>88</sup> Through this program, up to \$700 billion could be disbursed.<sup>89</sup> TBTF statutes grant considerable discretion to the relevant agencies, without providing clear guidance as to how and when the discretion should be used. How those agencies have exercised their discretion has established the changing parameters of the government's TBTF policy.

#### A. *Continental Bank of Illinois and FDICIA*

The most prominent case for the FDIC acting under Section 13(c)(2) of FDIA is that of Continental Bank of Illinois in 1984.<sup>90</sup> Continental, a leading commercial lender, became insolvent due to a run of wholesale deposits from around the world.<sup>91</sup> Concerned over the potential adverse consequences that the failure of Continental could have on the entire banking system, the FDIC decided to intervene. First, to address the short-term problem, the FDIC provided a \$1.5 billion subordinated loan, which could be called at any time with the FDIC Board's approval.<sup>92</sup> The FDIC granted the loan under Section 13(c)(2).<sup>93</sup> The FDIC had made a finding of essentiality, but the press release at the time did not mention this.<sup>94</sup> Furthermore, the FDIC, in connection with the subordinated loan, granted 100% protection to all depositors (including uninsured depositors) and all general creditors.<sup>95</sup> Meanwhile, the FDIC continued searching for banks interested in acquiring Continental while making the depositors and creditors whole in the process.<sup>96</sup> However, no buyer was found.<sup>97</sup>

Two months later, the FDIC decided to act under Section 13(c)(2) of FDIA again and provide a bailout.<sup>98</sup> The bailout package consisted of the FDIC purchasing the bad loans and injecting new capital into the

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<sup>87</sup> Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 § 1145(a), 122 Stat. 2654, 2734-35 (2008).

<sup>88</sup> Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101(a), 122 Stat. at 3765, 3767 (2008).

<sup>89</sup> *Id.* at § 115(a).

<sup>90</sup> See generally Sprague, *supra* note 29, at 149-228.

<sup>91</sup> *Id.* at 149.

<sup>92</sup> *Id.* at 159-60.

<sup>93</sup> *Id.* at 161.

<sup>94</sup> *Id.* at 162. (Sprague, a member of the FDIC Board at the time of the bailout, wrote in his book: "We had made an essentiality finding, but it was not mentioned in the press release.")

<sup>95</sup> *Id.*

<sup>96</sup> FDIC History, *supra* note 40, at 244; Sprague, *supra* note 29, at 170.

<sup>97</sup> FDIC History, *supra* note 40, at 244; Sprague, *supra* note 29, at 170.

<sup>98</sup> *Id.*

bank.<sup>99</sup> The FDIC purchased \$4.5 billion in bad loans for \$3.5 billion, and the bank continued to manage those loans under a servicing contract.<sup>100</sup> The bank had to write off the \$1 billion loss for the loan transfer, but the FDIC acquired \$1 billion of preferred non-voting stock in Continental's holding company to replace the loss.<sup>101</sup> The holding company was required to downstream the FDIC's investment to the bank as equity.<sup>102</sup> A new bank holding company was created, and all the outstanding common stock of Continental Bank was transferred to it.<sup>103</sup> Continental's top management and Board of Directors were removed and replaced by officers that the FDIC chose.<sup>104</sup> The actions under Section 13(c)(2) protected both depositors (including uninsured depositors) and creditors of the Bank. On September 19, 1984, the House Banking Committee held a hearing about the rescue of Continental Illinois Bank & Trust Co. of Chicago.<sup>105</sup>

### B. Long Term Capital Management and Fed's Pressure

Long Term Capital Management (LTCM) was a hedge fund in Greenwich, Connecticut.<sup>106</sup> This hedge fund was founded in 1993 by an elite group of individuals including: Myron Scholes and Robert C. Merton, Nobel Prize-winning economists; John Meriwether, former vice chairman of Salomon Brothers; David Mullins, former vice chairman of the Fed; and Eric Rosenfeld, former professor at Harvard University.<sup>107</sup> The idea behind this hedge fund was that its investments could be grouped in such a way that risk was reduced to almost zero.<sup>108</sup> The fund's strategy was to make many small profits.<sup>109</sup> The fund proved to be very successful from 1994 through 1998.<sup>110</sup>

The fund was investing in international markets as well. The East Asian financial crisis of 1997 and the Russian financial crisis of 1998 were

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<sup>99</sup> Sprague, *supra* note 29, at 209.

<sup>100</sup> FDIC History, *supra* note 44, at 244.

<sup>101</sup> Sprague, *supra* note 29, at 209-210.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at 210.

<sup>104</sup> *Id.* at 205-06, 210.

<sup>105</sup> Tim Carrington, *U.S. Won't Let 11 Biggest Banks In Nation Fail*, WALL ST. J., Sept. 20, 1984, at A2.

<sup>106</sup> Edward Pekarek, *Pruning the Hedge: Who is a "Client" and Whom does an adviser advise?*, 12 FORDHAM J. CORP. & FIN. L. 913, 949 (2007).

<sup>107</sup> Thayer Watkins, Long Term Capital Management, (Aug. 17, 2009), <http://www.sjsu.edu/faculty/watkins/lcm.htm>.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* ("Myron Scholes stated the objective of LTCM in a striking image. He said LTCM would function like a giant vacuum cleaner sucking up nickels that everyone else had overlooked.")

<sup>110</sup> *Id.*



factors in giving rise to the failure of the fund.<sup>111</sup> As of August 1, 1998, LTCM's equity was \$4.1 billion; however, during the next thirty days, its equity dropped to \$2.3 billion.<sup>112</sup> Finally, by the third week of September of 1998, the equity of the fund was reduced from \$2.3 billion to \$600 million, which elevated leverage in a significant manner.<sup>113</sup> Banks became concerned that their proprietary positions were not covered.<sup>114</sup> During the weekend of September 19 and 20, some banks discussed unwinding their exposure, but not all the banks could do it at the same time.<sup>115</sup> LTCM needed immediate intervention.<sup>116</sup>

On Sunday, September 20, the Fed intervened because of the fear of systemic risk. Although lacking jurisdiction over hedge funds, the Fed chose to act.<sup>117</sup> In that spirit, the only immediate option the Fed saw was a consortium.<sup>118</sup> The Fed started to work out the details of the consortium and invited representatives of the most influential financial institutions at the time to convene at the Federal Reserve Bank of New York.<sup>119</sup> The bankers, pressured by the Fed, came up with an agreement.<sup>120</sup> The consortium would inject about \$3.5 billion in exchange for a 90% stake in the fund.<sup>121</sup> Bankers Trust, Barclays, Chase, Deutsche Bank, UB, Salomon Smith Barney, J.P. Morgan, Goldman Sachs, Merrill Lynch, Credit Suisse First Boston, and Morgan Stanley each contributed \$300 million. Société Générale contributed \$125 million, while Credit Agricole, Bank Paribas and Lehman Brothers contributed \$100 million each.<sup>122</sup> There was no guarantee by the Fed to any of the institutions participating in the bailout.

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<sup>111</sup> Professor Jomo K. S., Visiting Senior Research Fellow, Asia Research Institute, National University of Singapore, *Beyond Miracle and Debacle in East Asia*, (Nov. 24 2004), available at <http://www.ari.nus.edu.sg/showfile.asp?eventfileid=195>.

<sup>112</sup> Ludwig B. Chincarini, *The Failure of Long-Term Capital Management* (Oct. 8, 1998), available at <http://ssrn.com/abstract=952512>.

<sup>113</sup> *Id.*

<sup>114</sup> Watkins, *supra* note 107.

<sup>115</sup> Steven Lipin, Matt Murray & Jacob M. Schlesinger, *Bailout Blues: How a Big Hedge Fund Marketed Its Expertise And Shrouded Its Risks --- Regulators and Lenders Knew Little About the Gambles At Long-Term Capital --- 'Stardust' in Investors' Eyes*, WALL ST. J., Sept. 25, 1998, at A1.

<sup>116</sup> ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* 197 (Random House 2000).

<sup>117</sup> Anita Raghavan & Mitchell Pacelle, *To the Rescue? A Hedge Fund Falts, So the Fed Persuades Big Banks to Ante Up --- Firms to Lend \$3.6 Billion As Long-Term Capital Loses on Its Bond Bets --- 'Star Power' and Red Ink*, WALL ST. J., Sept. 24, 1998, at A1.

<sup>118</sup> LOWENSTEIN, *supra* note 116 at 196-98.

<sup>119</sup> *Id.* at 199-201.

<sup>120</sup> *Id.* at 204-208.

<sup>121</sup> Raghavan & Pacelle, *supra* note 117.

<sup>122</sup> Lipin, Murray & Schlesinger, *supra* note 115.

By 2000, the fund was completely liquidated and the consortium was paid back.

### C. Bear Stearns and FRA

In March of 2008, the government faced the first major disaster of what until then had been considered a crisis confined to the subprime mortgage market: Bear Stearns (Bear), a large investment bank, was about to collapse.<sup>123</sup> Unlike Continental Bank, Bear, as an investment bank, was not under the protection of the FDIC, so its possible failure did not call for the FDIC's intervention. The Fed decided to act by providing Bear with a twenty-eight day emergency loan through JP Morgan.<sup>124</sup> Later that month, the Fed relied on Section 13(3) of the FRA to bail out Bear by providing a loan through JP Morgan, who was buying Bear, of almost \$30 billion.<sup>125</sup> Under Section 13(3) of the FRA, the Fed has the authority to open the discount window to anyone, as long as it is approved by at least five members of the Fed and complies with the standards of the statute.<sup>126</sup> It was only the second time the Fed relied on Section 13(3) in seventy-five years.<sup>127</sup> Following the procedure stated in the statute, the Fed determined that the circumstances were "unusual and exigent" in light of the weak financial markets and the interconnectedness of Bear.<sup>128</sup> Also, the Fed concluded that Bear was "unable to secure adequate credit accommodations elsewhere."<sup>129</sup> The four members present at the meeting unanimously approved the non-recourse loan collateralized by a pool of Bear assets and determined that the action was required before the other board member could return and participate, therefore complying with the procedure set in

<sup>123</sup> Samar Srivastava & Jeff Kearns, *Bear Stearns Falls to 5-Year Low on Capital Concern*, BLOOMBERG PRESS, Mar. 13, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a69chRKaI0mo>.

<sup>124</sup> Stephen Bernard, *JPMorgan Chase Funding Bear Stearns: Bear Stearns lost half of its value within 30 minutes of the market open*, INT'L BUS. TIMES, Mar. 14, 2008, available at <http://www.ibtimes.com/articles/20080314/jpmorgan-chase-funding-bear-stearns.htm>.

<sup>125</sup> Todd, *supra* note 54.

<sup>126</sup> 12 U.S.C.S. § 343 (2008).

<sup>127</sup> David Fetting, Fed. Reserve Bank of Minneapolis, *The History of a Powerful Paragraph* (2008), available at [http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=3485](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3485).

<sup>128</sup> *Turmoil in U.S. credit markets: examining the recent action of federal financial regulators: Hearing Before the S. Banking, Housing and Urban Affairs Comm.* 110th Cong. 2 (2008) (statement of Ben Bernanke, Chairman of the Federal Reserve Board of Governors), available at [http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=0a0ec016-ad61-4736-b6e3-7eb61fbc0c69](http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0a0ec016-ad61-4736-b6e3-7eb61fbc0c69).

<sup>129</sup> Bd. of Governors of the Fed. Reserve Sys. Minutes (Mar. 14, 2008), available at <http://www.federalreserve.gov/newsevents/press/other/other20080627a1.pdf>.

the statute.<sup>130</sup> Two days later, the Fed also authorized the Federal Reserve Bank of New York to make the discount window available to all the primary securities dealers. This decision was based on “recent, rapidly changing developments.”

#### *D. Lehman Brothers and Chapter 11 Bankruptcy*

The next challenge the government faced was Lehman Brothers’ (Lehman) imminent collapse.<sup>131</sup> Lehman, another large investment bank, had significant investments in real estate related holdings that had gone bad, and the firm could not raise new capital to offset losses from these investments.<sup>132</sup> As Lehman’s situation quickly worsened, the expectations were that Lehman would be bailed out, given that Lehman was bigger than Bear, and Lehman was more involved in the mortgage-backed securities market, which could result in more chaos than Bear’s collapse.<sup>133</sup> Rumors also were circulating as to who would buy Lehman.<sup>134</sup> No buyer stepped forward, and the government decided not to rescue Lehman.<sup>135</sup> Lehman filed for bankruptcy on September 15, 2008.<sup>136</sup> Secretary of the Treasury

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<sup>130</sup> *Id.* (clarifying that even though the statute requires at least five members to consent, only four members of the Board were present at the meeting where the action was authorized). According to the minutes of the meeting, the FRA requires that when fewer than five members are present the vote must be unanimous and the action must be necessary before the other member will be available. See Federal Reserve Act § 11(r), 12 U.S.C. § 248(r) (2006).

<sup>131</sup> Jenny Anderson & Andrew Ross Sorkin, *Lehman Said to Be Looking for a Buyer as Pressure Builds*, N.Y. TIMES, Sept. 10, 2008, at A1.

<sup>132</sup> Paul R. La Monica, *Lehman: Too Big to Fail?*, CNN MONEY.COM, <http://money.cnn.com/2008/09/10/markets/thebuzz/>; Rachel Beck, *All Business: Lehman Shows Few are Too Big to Fail*, INT’L BUS. TIMES, Sept. 16, 2008, available at <http://www.ibtimes.com/articles/20080916/all-business-lehman-shows-few-are-too-big-to-fail.htm> (describing that expectations came from the fact that Lehman was larger than Bear, and Lehman was more involved in the mortgage-backed securities market which could result in more chaos than Bear’s collapse).

<sup>133</sup> *Id.*

<sup>133</sup> Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 14, 2008, at A1.

<sup>133</sup> Press Release, Lehman Bros. Holdings, Lehman Bros. Holdings Inc. Announces It Intends to File Chapter 11 Bankruptcy Petition (Sept. 15, 2008), available at [http://www.lehman.com/press/pdf\\_2008/091508\\_lbhi\\_chapter11\\_announce.pdf](http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf).

<sup>134</sup> *Id.*

<sup>135</sup> Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 14, 2008, at A1.

<sup>136</sup> Press Release, Lehman Bros. Holdings, Lehman Bros. Holdings Inc. Announces It Intends to File Chapter 11 Bankruptcy Petition (Sept. 15, 2008), available at [http://www.lehman.com/press/pdf\\_2008/091508\\_lbhi\\_chapter11\\_announce.pdf](http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf).

Paulson stated that bailing out Lehman was not an option he considered because of the moral hazard issue.<sup>137</sup> In retrospect, Paulson maintained that letting Lehman fail was the right decision, especially because there was no buyer for Lehman.<sup>138</sup>

### E. *AIG and FRA*

Days after Lehman's bankruptcy filing, the Fed faced another failing institution: American International Group (AIG). AIG, the largest insurer in the world, got in trouble when its credit ratings were downgraded<sup>139</sup> to the point where it needed to post \$14 billion more in collateral for credit-default swaps.<sup>140</sup> AIG's assets amount to \$1.1 trillion, with more than seventy million customers, including many of the world's biggest and most important financial firms.<sup>141</sup> On September 16, 2008, the Fed authorized the Federal Reserve Bank of New York to create a line of credit of up to \$85 billion for AIG.<sup>142</sup> The loan was collateralized by AIG's assets and the assets of "its primary non-regulated subsidiaries."<sup>143</sup>

<sup>137</sup> Martin Crutsinger, *Paulson Says Lehman Bailout was Never an Option*, INT'L HERALD TRIB., Sept. 15, 2008, available at <http://www.iht.com/articles/ap/2008/09/15/business/NA-US-Paulson-Markets.php>; Ziad Raymond Azar, *Bankruptcy Policy: A Review and Critique of Bankruptcy Statutes and Practices in Fifty Countries Worldwide*, 16 CARDOZO J. INT'L & COMP. L. 279, 293 n.36 (2008) ("Moral hazard is the risk that an economic player will change (inefficiently) its behavior because of the (real or perceived) decrease in the cost that is associated with taking a particular action.").

<sup>138</sup> Martin Crutsinger, *Paulson says Global Markets Remain Strained*, INT'L HERALD TRIB., Oct. 8, 2008, available at <http://www.iht.com/articles/ap/2008/10/08/business/NA-US-Meltdown-Paulson.php>.

<sup>139</sup> Chua Kong Ho & Shani Raja, *Asian Stocks Extend Global Rout on AIG Downgrade; Banks Fall*, BLOOMBERG.COM, Sept. 16, 2008, [http://www.bloomberg.com/apps/news?pid=20601080&sid=aHhtaYZ\\_NzVI](http://www.bloomberg.com/apps/news?pid=20601080&sid=aHhtaYZ_NzVI) ("The ratings downgrades occurred after two people familiar with the situation said that the biggest U.S. insurer by assets is seeking \$70 billion to \$75 billion in loans arranged by Goldman Sachs Group Inc. and JPMorgan Chase & Co. to replenish capital.").

<sup>140</sup> Andy Serwer & Allan Sloan, *The Price of Greed*, TIME, Sept. 29, 2008, at 32, 35.

<sup>141</sup> Tami Luhby, *Why the Fed Pulled the Trigger on AIG*, CNNMONEY.COM, Sep. 17, 2008, [http://money.cnn.com/2008/09/17/news/companies/aig\\_explainer/index.htm](http://money.cnn.com/2008/09/17/news/companies/aig_explainer/index.htm).

<sup>142</sup> Edmund L. Andrews et al., *Fed's \$85 Billion Loan Rescues Insurer*, N.Y. TIMES.COM, Sept. 16, 2008, [http://www.nytimes.com/2008/09/17/business/17insure.html?\\_r=1&scp=1&sq=Fed's%20%2485%20Billion%20Loan%20Rescues%20Insurer&st=cse](http://www.nytimes.com/2008/09/17/business/17insure.html?_r=1&scp=1&sq=Fed's%20%2485%20Billion%20Loan%20Rescues%20Insurer&st=cse).

<sup>143</sup> Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 16, 2008), available at <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>.

In exchange for the loan, the government received a 79.9% equity interest in AIG and the “right to veto the payment of dividends to common and preferred shareholders.”<sup>144</sup> Once again relying on Section 13(3) of the FRA, the Federal Reserve Board, with the approval of five board members, decided to open the Fed’s loan facility to a non-commercial bank. The Fed stated that such action was necessary under the “current circumstances,” pointing to the “unusual and exigent” requirement.<sup>145</sup> Chairman Ben Bernanke expressed that the Fed prevented AIG’s default because a “disorderly failure of AIG would have severely threatened global financial stability and the performance of the U.S. economy.”<sup>146</sup> Nothing further was mentioned at the time as to the Fed’s compliance with any of the other requirements of Section 13(3). For example, the Fed was silent as to the statute’s requirements that AIG have exhausted all other sources of credit. On October 8, 2008, the Fed relied on Section 13(3) again. This time the Fed authorized the Federal Reserve Bank of New York to “borrow up to \$37.8 billion in investment-grade, fixed-income securities from AIG in return for cash collateral.”<sup>147</sup> The Fed did not reveal anything as to the application of the factors of Section 13(3); the only explanation was that this action would allow AIG to “replenish liquidity.”<sup>148</sup>

#### F. *Wachovia and FDICIA*

For seventeen years, the “systemic risk” exception of the FDICIA went unused. On September 26, 2008, Wachovia’s stock plummeted 27% and depositors started to withdraw from their accounts any excess of \$100,000 (what was insured by the FDIC at the time).<sup>149</sup> Out of concern for the effects of a possible failure, on September 29, the FDIC acted for the first time under the systemic risk exception of the 1991 FDICIA and ordered Wachovia to sell itself to Citigroup.<sup>150</sup> Before giving such order,

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<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Address at the National Association for Business Economics 50th Annual Meeting, Washington, D.C.: Current Economic and Financial Conditions Oct. 7, 2008, available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081007a.htm>.

<sup>147</sup> Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 8, 2008), available at <http://www.federalreserve.gov/newsevents/press/other/20081008a.htm>.

<sup>148</sup> *Id.*

<sup>149</sup> Peter St. Onge, *Stunningly Swift Fall for Wachovia: Sale to Citigroup Technically Keeps Bank from Failing, but Layoffs are Still Likely*, CHARLOTTE OBSERVER, Sept. 30, 2008, available at <http://www.charlotteobserver.com/408/story/222685.htm>.

<sup>150</sup> Rick Rothacker & Kerry Hall, *Wachovia Faced a ‘Silent’ Bank Run*, CHARLOTTE OBSERVER, Oct. 2, 2008, available at

as determined by FDICIA, the FDIC and the Fed made the recommendation to the Secretary of the Treasury.<sup>151</sup> The Secretary of the Treasury, in consultation with the President, gave the approval.<sup>152</sup> Secretary of the Treasury Paulson stated: "I agree with the FDIC and the Federal Reserve that a failure of Wachovia would have posed a systemic risk."<sup>153</sup> As a result, all of Wachovia's creditors were protected.<sup>154</sup> As part of the arrangement, the FDIC agreed to take on all the losses in Wachovia's loan and investment portfolio in excess of \$42 billion (that was assumed by Citigroup) from a pool of \$312 billion in loans, in exchange for \$12 billion in preferred stock and warrants in Citigroup.<sup>155</sup> Wachovia, however, ended up refusing the deal with Citigroup, and sold itself to Wells Fargo in an unassisted transaction. On October 12, the Fed approved the Wells Fargo acquisition.<sup>156</sup>

### G. Fannie Mae, Freddie Mac and HERA

On Sunday, September 7, 2008, after regulating GSEs for a little over a month, the FHFA appointed itself as the conservator of Freddie Mac and Fannie Mae. The preceding Friday, Fannie and Freddie's shares fell more than 80% as of the end of the day's trading.<sup>157</sup> Also, FHFA's action was a response, in part, to government's fears that "foreigners wouldn't continue funding our trade and federal-budget deficits."<sup>158</sup> In his statement, the Director of the FHFA, James B. Lockhart, stated that the actions were in response to safety and soundness concerns at the GSEs.<sup>159</sup> Besides safety and soundness concerns, Lockhart's determination was based on the condition of the current market, Freddie's and Fannie's financial performance and condition, their "inability to fund themselves according to

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<http://www.charlotteobserver.com/408/story/226799.html?q=wachovia%20faced%20a%20silent%20bank%20run>.

<sup>151</sup> Press Release, FDIC (Sept. 29, 2008) [hereinafter FDIC Sept. 29 Press Release], available at <http://www.fdic.gov/news/news/press/2008/pr08088.html>.

<sup>152</sup> *Id.*

<sup>153</sup> Press Release, U.S. Dep't. of the Treasury, Statement by Henry Paulson, U.S. Sec'y of the Treasury, on the Sale of Wachovia Bank (Sept. 29, 2008), available at <http://www.ustreas.gov/press/releases/hp1164.htm>.

<sup>154</sup> FDIC Sept. 29 Press Release, *supra* note 151.

<sup>155</sup> Opinion, *Pre-emptive Plumbing*, WALL ST. J., Sept. 30, 2008, at A18.

<sup>156</sup> Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 12, 2008), available at

<http://www.federalreserve.gov/newsevents/press/orders/20081012a.htm>.

<sup>157</sup> David Ellis, *U.S. Seizes Fannie and Freddie*, CNN MONEY.COM (Sept. 7, 2008), [http://money.cnn.com/2008/09/07/news/companies/fannie\\_freddie/index.htm](http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm).

<sup>158</sup> Serwer & Sloan, *supra* note 140.

<sup>159</sup> Press Release, Office of Fed. Hous. Enterprise Oversight, Statement of James B. Lockhart, Director, Fed. Hous. Fin. Agency (Sept. 7, 2008) [hereinafter FHFA Press Release], available at

[http://treasury.gov/press/releases/reports/fhfa\\_statement\\_090708hp1128.pdf](http://treasury.gov/press/releases/reports/fhfa_statement_090708hp1128.pdf).

normal practices and prices,” and the important role that Freddie and Fannie play in the residential mortgage market.<sup>160</sup> Although HERA gives Lockhart broad discretion to place a GSE into conservatorship, he also relied somewhat on the “insight and perspective” of the Federal Reserve and the Office of the Comptroller of the Currency.<sup>161</sup> Freddie and Fannie consented to Lockhart’s decision of placing the FHFA as their conservator, as consent is an acceptable ground to make the appointment.<sup>162</sup> As part of the conservatorship, the FHFA assumed the power of the Board and management and replaced the CEOs of both GSEs.<sup>163</sup> The plan also committed the Treasury to provide up to \$100 billion to each GSE<sup>164</sup> through the purchase of preferred stock.<sup>165</sup>

#### H. *Capital Purchase Program, Liquidity Guarantee Program, EESA and FDICIA*

On October 14, 2008, the Secretary of the Treasury outlined how it would use the first \$250 billion in the implementation of EESA.<sup>166</sup> The Treasury introduced the voluntary Capital Purchase Program, in which a broad array of financial institutions could participate and sell shares of preferred stock to the government. The stated purpose of the program at the time was to improve the lending capacity of these institutions and promote economic growth.<sup>167</sup> Complying with the “two-day” EESA provision, the Treasury published the details of TARP the same day that it announced the program. According to the publication, TARP is available by application to bank and financial holding companies, and savings and loan holding companies engaged only in financial activities authorized by the law.<sup>168</sup> The

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<sup>160</sup> *Id.* Lockhart had discretionary appointment. He did not need to make any of these findings, only one ground was needed, and in this case, Freddie and Fannie consented. Consent is an acceptable ground.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*; see also Zachary A. Goldfarb et al., *Treasury to Rescue Fannie and Freddie*, WASH. POST, Sept. 7, 2008 at A01.

<sup>163</sup> FHFA Press Release, *supra* note 159.

<sup>164</sup> Stephen Labaton & Edmund Andrews, *In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, NYTIMES.COM, Sept. 7, 2008 available at <http://www.nytimes.com/2008/09/08/business/08fannie.html>.

<sup>165</sup> Fact Sheet, U.S. Dep’t of the Treasury, Office of Public Affairs, Treasury Senior Preferred Stock Purchase Agreement, Sept. 7, 2008, available at [http://ustreas.gov/press/releases/reports/pspa\\_factsheet\\_090708%20hp1128.pdf](http://ustreas.gov/press/releases/reports/pspa_factsheet_090708%20hp1128.pdf).

<sup>166</sup> Deborah Solomon & David Enrich, *Devil Is in Bailout's Details --- Government's \$250 Billion Cash Injection Sparks Welter of Issues*, WALL ST. J., Oct. 15, 2008 at A1.

<sup>167</sup> Press Release, U.S. Dep’t of the Treasury, Joint Statement by Treasury, Federal Reserve and FDIC (Oct. 14, 2008) [hereinafter Joint Release], available at <http://treas.gov/press/releases/hp1206.htm>.

<sup>168</sup> U.S. Dep’t of the Treasury, Application Guidelines for TARP Capital Purchase Program (Nov. 17, 2008) [hereinafter TARP CPP Guidelines], available at <http://treas.gov/press/releases/reports/applicationguidelines.pdf>.

Treasury, in consultation with the appropriate federal banking agency for the applicant, would decide whether the applicant is eligible for TARP.<sup>169</sup> The Treasury would acquire non-voting senior preferred shares that pay a cumulative dividend rate of five percent a year for the first five years and a rate of nine percent a year thereafter.<sup>170</sup> The shares are callable at par after three years, or redeemable before then “with the proceeds from a qualifying equity offering of any Tier 1 perpetual preferred or common stock.”<sup>171</sup> The Treasury also receives warrants to purchase common stock limited to fifteen percent of its total investment in the institution.<sup>172</sup> Moreover, to comply with the unjust enrichment provision, the Treasury requires the participating organizations to adopt certain standards that relate to prohibiting excessive compensation of senior executives.<sup>173</sup>

At the time the Secretary of the Treasury introduced the program, he also announced that nine major financial institutions had already agreed to participate in the program.<sup>174</sup> There is no mention of these institutions applying to TARP. The Treasury essentially forced nine U.S. banks to participate in the program and offered a total of \$125 billion to these nine institutions.<sup>175</sup> Some of the institutions and the amount that the Treasury agreed to buy from each were: Bank of America (including recently acquired Merrill Lynch), J.P. Morgan, Citigroup and Wells Fargo, \$25 billion from each; Goldman Sachs and Morgan Stanley, \$10 billion from each; Bank of New York Mellon, \$3 billion; and about \$2 billion from State Street.<sup>176</sup> The remaining \$125 billion has been made available to medium and small institutions that apply, subject to approval.<sup>177</sup>

In the same press release, the FDIC joined the Fed in announcing another new program.<sup>178</sup> The FDIC’s program consisted of temporarily guaranteeing senior debt of all institutions already insured by the FDIC and the senior debt of some holding companies.<sup>179</sup> The FDIC would also guarantee deposits in “non-interest bearing deposit transaction accounts.”<sup>180</sup> The FDIC relied on the systemic risk exception under

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<sup>169</sup> Press Release, U.S. Dep’t of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), *available at* <http://www.treas.gov/press/releases/hp1207.htm> (last visited Aug. 23, 2009).

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.* (“Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15 percent of the senior preferred investment.”)

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> Deborah Solomon & David Enrich, *supra* note 166 (stating that the government agreed to buy \$25 billion each from Bank of America, J.P. Morgan, Citigroup and Wells Fargo, \$10 billion from Goldman Sachs and Morgan Stanley, \$3 billion from Bank of New York Mellon, and around \$2 billion from State Street Bank).

<sup>176</sup> *Id.*

<sup>177</sup> *Id.*

<sup>178</sup> Joint Release, *supra* note 167.

<sup>179</sup> *Id.*

<sup>180</sup> *Id.*



FDICIA.<sup>181</sup> The Fed and FDIC made a written recommendation to the Secretary of the Treasury, who then consulted with the President and made the determination.<sup>182</sup> After the systemic risk finding, the FDIC was allowed to take actions to mitigate the adverse effects on economic conditions and on stability of the system.<sup>183</sup> The program has two main parts: the debt guarantee program and the transaction account guarantee program. The debt guarantee program consists of guaranteeing a certain amount of the newly-issued senior unsecured debt until June 30, 2009.<sup>184</sup> The FDIC believed that this program would provide liquidity to the market and promote stability in the unsecured funding market while it discouraged complex funding structures and risky loans.<sup>185</sup> The second part, the transaction account guarantee program, would fully protect funds held in non-interest bearing transaction accounts of FDIC-insured institutions and exceeding the current deposit insurance limit.<sup>186</sup> Interestingly, if the assessments of the program are not sufficient to pay for the expenses, then a special assessment under U.S.C. § 1823 (c)(4)(G)(ii) would be made against all insured depository institutions regardless of their participation in this program.<sup>187</sup>

### I. Citigroup, EESA and FDICIA

Citigroup, the second largest U.S. bank by assets,<sup>188</sup> was one of the large financial institutions that seemed to be standing still in the midst of the financial crisis. On Friday, November 21, 2008, the giant succumbed when the price of its stock went down to \$3.77, 60% lower than at the beginning of the week and totaling a 72% loss during the month of November.<sup>189</sup> Critics speculate that the cause of such plunge in the stock price was the Treasury's announcement earlier in the month that it would no longer buy toxic assets from banks.<sup>190</sup> As the situation worsened, Citigroup's top officers and government officials started to look for options

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<sup>181</sup> *Id.*

<sup>182</sup> *Id.*; FDIC, Temporary Liquidity Guarantee Program 73 Fed. Reg. 72244 (Nov. 26, 2008) [hereinafter TLGP].

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* at 72245.

<sup>185</sup> *Id.*

<sup>186</sup> *Id.* at 72246.

<sup>187</sup> *Id.* at 72250.

<sup>188</sup> Dan Wilchins & Jonathan Stempel, *Citigroup Shares Drop; CEO Plans to Keep Smith Barney*, REUTERS, Nov. 21, 2008, available at <http://www.reuters.com/article/ousiv/idUSTRE4AJ45G20081121>.

<sup>189</sup> Rob Curran, *Large Stock Focus: Citigroup's November Swoon: Down 72%*, WALL ST. J., Nov. 22, 2008, at B3.

<sup>190</sup> *Id.*; Press Release, U.S. Dep't of the Treasury, Remarks by Sec'y Henry M. Paulson on Financial Rescue Package and Economic Update, available at <http://ustreas.gov/press/releases/hp1265.htm> (declaring that Treasury was not planning to buy distressed mortgage assets anymore).

to stabilize the company and boost investors' confidence.<sup>191</sup> Late on Sunday, November 23, the FDIC, Fed and Treasury revealed a bailout plan.<sup>192</sup> The plan included a series of transactions between Citigroup, FDIC, Fed and Treasury.<sup>193</sup> The Treasury, FDIC and Fed will protect the company against losses in a \$306 billion pool of loans and securities backed by real estate and other similar assets.<sup>194</sup> Citigroup will keep these assets on its balance sheet.<sup>195</sup> Citigroup is responsible for the first \$29 billion in losses in the pool of assets and 10% of the remainder of the losses.<sup>196</sup> The Treasury agreed to cover the next \$5 billion in losses in the pool of assets, and the FDIC will cover the next \$10 billion in losses.<sup>197</sup> The Fed agreed to cover all losses beyond that point through a non-recourse loan.<sup>198</sup> In exchange for the protection, Citigroup issued non-voting preferred stock to the FDIC and the Treasury.<sup>199</sup> Citigroup agreed to submit an executive compensation plan with restrictions to be approved by the government.<sup>200</sup> Also, the Treasury invested \$20 billion in Citigroup from TARP in exchange for non-voting preferred stock with an 8% dividend.<sup>201</sup> The agencies stated that the actions were "necessary to strengthen the financial system and protect U.S. taxpayers and the U.S. economy."<sup>202</sup> The FDIC relied on the systemic risk exception under FDICIA and voted unanimously to get involved in the Citigroup rescue.<sup>203</sup> The Treasury relied on their authority under EESA to disburse the TARP funds.<sup>204</sup> The rapid reaction and the extent of the Citigroup bailout increased the criticism that the government "is willing to do anything to bail out the biggest banks, while letting smaller ones, consumers, and small companies, fail."<sup>205</sup>

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<sup>191</sup> David Enrich et al., *U.S. Agrees to Rescue Struggling Citigroup--- Plan Injects \$20 Billion in Fresh Capital, Guarantees \$306 Billion in Toxic Assets*, WALL ST. J., Nov. 24, 2008, at A1.

<sup>192</sup> Press Release, U.S. Dep't of the Treasury, Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup (Nov. 23, 2008), *available at* <http://ustreas.gov/press/releases/hp1287.htm>.

<sup>193</sup> *Id.*

<sup>194</sup> *Id.*

<sup>195</sup> U.S. Dep't of the Treasury, Summary of Terms (Nov. 23, 2008), *available at* [http://ustreas.gov/press/releases/reports/cititermsheet\\_112308.pdf](http://ustreas.gov/press/releases/reports/cititermsheet_112308.pdf).

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> *Id.* (allocating \$4B to the Treasury and \$3B to the FDIC, and 8% dividend rate).

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*

<sup>202</sup> *Id.*

<sup>203</sup> Damian Paletta, *FDIC Vote on Citi Was Unanimous*, WALL ST. J., Nov. 24, 2008, *available at* <http://online.wsj.com/article/SB122753695817253015.html> article/SB122753695817253015.html?mod=googlenews\_wsj.

<sup>204</sup> See *supra* notes 5179-86 and accompanying text.

<sup>205</sup> Damian Paletta & Deborah Solomon, *Uncertainty on Strategy in Citi Rescue*, WALL ST. J., Nov. 25, 2008, at A10.

### J. Bank of America and EESA

As the financial crisis prolonged through the end of 2008 and into 2009, Bank of America (BoFA) found itself severely affected. On September 15, 2008, BoFA offered to buy Merrill Lynch for \$50 billion in a stock for stock transaction.<sup>206</sup> On December 5, 2008, BoFA's shareholders approved the merger.<sup>207</sup> With the purchase of Merrill Lynch, BoFA also acquired huge debt and bad assets, resulting in more losses.<sup>208</sup> The Treasury announced the agreement with BoFA, on January 16, 2009, to provide "a package of guarantees, liquidity access and capital . . . ."<sup>209</sup> The Treasury and the FDIC provided protection to a pool of assets, including securities, backed by residential and commercial real estate loans, of about \$118 billion.<sup>210</sup> BoFA retained the first \$10 billion loss in this pool of assets, while the Treasury, the Fed and the FDIC shared the next \$10 billion of losses. The Treasury and the FDIC are responsible for 90% of any losses in excess of those \$20 billion, while BoFA assumed the remaining 10%.<sup>211</sup> The Treasury also made available a non-recourse plan to backstop residual risk.<sup>212</sup> Also, the Treasury invested another \$20 billion in BoFA from the TARP program for BoFA's issuance of 8% dividend preferred stock.<sup>213</sup> The Treasury relied on its authority under the TARP program in the EESA.<sup>214</sup> This transaction was part of the Targeted Investment Program, the guidelines of which were published in January 2, 2009, in accordance with Section 101(d) of EESA.<sup>215</sup>

<sup>206</sup> Press Release, Bank of America, Bank of America Buys Merrill Lynch Creating Unique Financial Services Firm (Sept. 15, 2008), *available at* [http://bankofamerica.mediaroom.com/index.php?s=press\\_releases&item=8255](http://bankofamerica.mediaroom.com/index.php?s=press_releases&item=8255).

<sup>207</sup> David Ellis, *BoFA Shareholders Approve Merrill Purchase*, CNN MONEY.COM, Dec. 5, 2008, [http://money.cnn.com/2008/12/05/news/companies/merrill\\_bofa/index.htm](http://money.cnn.com/2008/12/05/news/companies/merrill_bofa/index.htm). 2008/12/05/news/companies/merrill\_bofa/index.htm.

<sup>208</sup> *Bank of America Bail-out Agreed*, BBC NEWS, Jan. 16, 2009, <http://news.bbc.co.uk/1/hi/business/7832484.stm>.

<sup>209</sup> Press Release, U.S. Dep't of the Treasury, Treasury, Federal Reserve and the FDIC Provide Assistance to Bank of America (Jan. 16, 2009), *available at*, <http://ustreas.gov/press/releases/hp1356.htm>.

<sup>210</sup> *Id.*

<sup>211</sup> Patrick Rucker & Jonathan Stempel, *Bank of America gets big Government Bailout*, REUTERS, Jan. 16, 2009, <http://www.reuters.com/article/topNews/idUSTRE50F1Q720090116?feedType=RSS&feedName=topNews>.

<sup>212</sup> U.S. Dep't of the Treasury, *supra* note 191203.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> Press Release, U.S. Dep't of the Treasury, Treasury Releases Guidelines for Targeted Investment Program (Jan. 2, 2009), *available at*, <http://www.treasury.gov/press/releases/hp1338.htm>.

## VI. CRITIQUE OF THE CURRENT APPROACH

Viewed from the eye of the storm, it's hard to say much of anything positive about the current approach to TBTF. The very fact that it is being shaped by events on a monthly or weekly basis admits of a policy that is reactive rather than proactive. In truth, until the events of 2008, there was no TBTF policy at all, but rather a set of ill-defined authorizations to "do whatever it takes" in the face of systemic threats. Policymakers should be given a wide berth for their creative efforts in the midst of an unprecedented crisis.

As indicated, the statutory authority contained in the FDIC Act, the Federal Reserve Act, and the recent Housing and Economic Recovery Act, and their legislative histories, hardly provides direction to policymakers. Similarly, the laws' procedural mandates are inconsistent, which is not surprising in light of the time and circumstances of each law's enactment. More troubling is the rather random delegation of authority by Congress to four separate agencies and departments to weigh in on the fates of systemically significant institutions. That these departments and agencies have been able to coordinate their efforts at all, particularly during a transition of administrations, is remarkable in itself. What the current crisis has laid bare is the need for a centralized approach to this issue at the federal level.

Compounding the statutory incoherence and the absence of centralized authority with respect to TBTF has been a decade of over-reliance on the efficacy of market discipline to allay systemic risk. For example, in its 2007 report on the threats posed by private pools of capital, the President's Working Group confidently stated, "Market discipline by creditors, counterparties, and investors is the most effective mechanism for limiting systemic risk ..." <sup>216</sup> Even in the midst of the current crisis, the Treasury Department in its *Blueprint* for reform, while recognizing the need for a central systemic regulator, saw that regulator as merely a "complement" to market discipline, <sup>217</sup> proving that the old mindset of blind reliance on market discipline dies hard.

Gary Stern, one of the leading authorities on TBTF and President of the Federal Reserve Bank of Minneapolis, generously chalked up the failure of policymakers to develop a TBTF policy to their being preoccupied with more weighty matters: "So, *ex ante*, other issues may have reasonably

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<sup>216</sup> President's Working Group, Agreement among PWG and U.S. Agency Principals on Principles and Guidelines regarding Private Pools of Capital 3 (2007), available at [http://www.treas.gov/press/releases/reports/hp272\\_principles.pdf](http://www.treas.gov/press/releases/reports/hp272_principles.pdf).

<sup>217</sup> U.S. DEP'T OF THE TREASURY, THE DEP'T OF TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 15 (2008), available at <http://www.treasury.gov/press/releases/reports/Blueprint.pdf>.

seemed more important, even if, *ex post*, TBTF is now viewed as paramount,”<sup>218</sup> he ruefully observed. Whether the aversion to addressing the TBTF was worship at the altar of market discipline or preoccupation with other matters, the consequences of that inattention are currently being played out.

The reason the issue is “paramount” now lies not in the hundreds of billions of taxpayers’ dollars that have been devoted to failing firms. Rather, the irony is that the sheer randomness of the bailouts has so unsettled markets that a return to anything resembling a market economy is dubious. The line between firms whose uninsured creditors are protected by the government and those firms that do not enjoy this support has been erased. Years of the pursuit and glorification of corporate gigantism will not be reversed easily.

As the above chronicle of the 2008 bailouts demonstrates, sorting out *who* was TBTF has been difficult. Constructive ambiguity worked to the advantage of any firm that fell within its vague penumbra. Generally, for example, market participants are still scratching their heads over a Wachovia that was TBTF, demanding taxpayer support one day only to be sold in a market transaction days later. Similarly, the collateral damage from the Lehman bankruptcy, particularly with respect to the commercial paper and money market mutual funds markets, has caused much second-guessing of policymakers for their failure to intervene.

Equally mystifying was the *how* of each TBTF rescue operation. How the agencies went about the bailouts has caused as much uncertainty as has their targets of choice. Bailout models have included:

- Rescue and consolidation (JPMorgan Chase/Bear Stearns and Bank of America/Countrywide/Merrill),
- Rescue and downsizing (Citigroup),
- Rescue and disaggregation (AIG),
- Preservation (Fannie Mae/Freddie Mac),
- Triage (Bank of America), and
- Liquidity (FDIC’s Temporary Liquidity Guaranty Program).

Each rescue operation is, of course, different, and the desired immediate result is not necessarily the survival of the bailed-out firm, but the health of the financial system. Nevertheless, the lack of cohesion to be found in how the bailouts were conducted bears out the truism of one panel report: “Once a crisis has arisen, financial regulation has already failed.”<sup>219</sup>

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<sup>218</sup> Gary H. Stern, President, Fed. Reserve Bank of Minneapolis, Address at Winona State University: Too Big to Fail: The Way Forward (Nov. 13, 2008), available at [http://www.minneapolisfed.org/news\\_events/pres/stern11-13-08.pdf](http://www.minneapolisfed.org/news_events/pres/stern11-13-08.pdf).news\_events/pres/stern11-13-08.cfm.

<sup>219</sup> CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM 22 (2009).

VII. GETTING IT RIGHT THE NEXT TIME<sup>220</sup>

Starting with the Treasury's *Blueprint*, many of the reform proposals point to the glaring gap in the regulatory structure represented by the absence of an agency charged with the responsibility for monitoring and addressing systemic risk. The cost for that gap is the current recession. The same proposals go on to recommend that that gap be eliminated by appointing an agency with the task and appropriate tools to carry out the responsibility of ensuring financial stability.

The systemic risk puzzle has many parts of which TBTF is one. The current systemic crisis, for example, started its life in a small segment of the mortgage industry, an industry once thought to be an oasis of low-risk activity. By itself, subprime lending was not systemically threatening and was socially useful. However, a concatenation of actors from securitizers to mortgage brokers to rating agencies amplified the subprime market's impact and, in the process, revealed other serious weaknesses in the financial system. Evident in the chain of actors that served as catalysts for the crisis, naturally, were the world's largest and most complex financial institutions. These institutions were the accelerants of the crisis and, ironically, victims of it as well.

While large complex financial institutions can play a role in amplifying a crisis, we know from recent observation that these institutions, by their very size and complexity alone, pose a risk to the financial system. The risk comes in the form of a possible disorderly liquidation with unknown but potentially serious spillover effects on other institutions and markets.

The scope and scale of financial institutions has been shown to be accompanied by certain funding advantages. Some of these advantages are attributable to scale. Other funding advantages can be attributed to sound management while other advantages are due to market confidence in the firm's business model. In some instances, the funding advantage is attributable to the perception of creditors that large firms and their creditors will be protected in the event of the firms' meltdown. This implicit backing introduces an element of moral hazard to the operations of these firms and adds a feature of pro-cyclicality that makes government rescue less remote than it would be otherwise.

Thus, the systemic regulator in the new regulatory architecture must address risks in at least two forms: first, the correlation of risks across the system arising from products, asset prices, capital constraints, liquidity stresses, and exotic instruments; and, second, the risks to the system posed

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<sup>220</sup> Cornelius Hurley, *Getting It Right the Next Time on "Too Big to Fail"*, REUTERS, Sept. 2008, <http://www.reuters.com/article/reutersComService4/idUSTRE48S7XQ20080929>.

by large complex institutions.<sup>221</sup> It is to the later risk category, large complex institutions, that we now turn.

It may be argued that the *constructive ambiguity* policy served a useful purpose prior to 2008. It cannot be credibly claimed, however, that the policy as practiced in 2008 was at all useful. Not surprisingly, of the regulatory reform proposals reviewed by the author, none suggest that the constructive ambiguity policy be retained.

Stern has argued that two elements of a sound TBTF policy are: first, the appointment of “conservative” policymakers who instinctively view government bailouts with abhorrence;<sup>222</sup> and, second, affirmative signaling by the government that bailouts will not be forthcoming. In 2008, both of these conditions were in place in the form of a very conservative Treasury Secretary and a tangible message sent to market participants via the Lehman bankruptcy that the government would not intervene henceforth. Both the Secretary and the Lehman communication failed. In their place, we are left with a series of TBTF bailouts that have trivialized the very notion of government intervention to address systemic risk.<sup>223</sup>

Naturally, many of the reform proposals address the issue of systemic risk, or as some refer to it “systemic stability.” Policymakers, including Chairman Bernanke<sup>224</sup> and the presidents of the Reserve Banks of Minneapolis and Boston, Stern<sup>225</sup> and Rosengren,<sup>226</sup> have weighed in on the issue. Chairman Frank of the House Financial Services Committee has indicated that this issue is at the forefront of his committee’s agenda in addressing regulatory reform.

There appears to be an emerging consensus around the notion that the new regulatory order must include an arm of the government whose responsibility it is to monitor systemic risk and, when necessary, act upon such risks when they threaten the stability of the financial system. Similarly, the preponderant view appears to be that the Fed, as central banker to the U.S. and lender of last resort, should take on this authority

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<sup>221</sup> A third category of systemically significant enterprises is those banks and nonbanks providing essential infrastructure services such as custody, settlement, clearing and payment services. Often, these services involve significant credit relationships between the service providers and their customers.

<sup>222</sup> Stern & Feldman, *supra* note 2, at 94.

<sup>223</sup> See, e.g., Jonathan V. Last, *Are Pro Sports Too Big to Fail?*, WALL ST. J., Jan. 29, 2009, at W11, available at <http://online.wsj.com/article/SB123328241772832043.html>.

<sup>224</sup> Ben S. Bernanke, Chairman, Fed. Reserve Bank, Address at the Federal Reserve Bank of Kansas City Annual Economic Symposium: Reducing Systemic Risk (Aug. 22, 2008).

<sup>225</sup> Stern & Feldman, *supra* note 2.

<sup>226</sup> Eric S. Rosengren, President & Chief Executive Officer, Fed. Reserve Bank of Boston, Address at the International Centre for Business Information RiskMinds 2008 Conference: The Global Risk Regulation Summit: Some Principles to Consider in Future Regulatory Reform (Dec. 8, 2008).

and responsibility.<sup>227</sup> Whether it is the Fed or some new agency charged with the systemic issue, some replacement strategy for constructive ambiguity must be developed.

Chastened by the experiences of the last year, many commentators have recognized that the fatal flaw of the current policy lies in its opaqueness.<sup>228</sup> Stated differently, firms that pose systemic risks need to be identified in advance of a crisis. As observed below, both public and private actors are already identifying systemically significant institutions, with some of these receiving heightened regulatory scrutiny. This rather casual identification and regulation process, like the TBTF policy itself, is not working. What is needed is a more rigorous and transparent process for identifying TBTF firms and, once identified, a more rigorous and transparent regulatory regime applied to their operations. These two stages are referred to below as “define” and “inform,” but the key factor comes with the third stage. Read on...

### A. Defining TBTF Firms

In a real sense, regulators have been signaling for some time that certain large firms are TBTF through the capital indulgences granted to such firms. For banks, regulators have allowed massive amounts of investment obligations to pile up off-balance sheet in structured investment vehicles without any capital underpinning. The largest investment banks, by the same token, were given explicit permission by the SEC to operate at exceedingly high leverage ratios. The result of this regulatory signaling was that the largest banks and investment banks “...believed the federal government would never permit their creditors to suffer loss...”<sup>229</sup> Firm in this belief, the managements of TBTF firms took on additional risk and leverage and, for the most part, their estimates of government support proved correct.

While the managements and boards of directors of large firms were hearing and heeding the signals from their regulators, the same signals were being sent to the markets. As far back as the Continental Bank bailout, the Comptroller of the Currency explicitly identified eleven banks that he

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<sup>227</sup> On the role of the Fed there is less of a consensus than there is regarding the need for a systemic regulator. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-216, A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 52 (2009) [hereinafter GAO FRAMEWORK], available at <http://www.gao.gov/new.items/d09216.pdf>.

<sup>228</sup> Damian Paletta, et al., *U.S. Seeks to Stem Bank Fears: White House Plays Down Nationalization Talk as Stocks Hit New Bear-Market Low*, WALL ST. J., Feb. 21, 2009, at A1 (noticing that an unnamed source mockingly referred to the policy as “destructive ambiguity”).

<sup>229</sup> Litan and Baily, *supra* note 23.



considered too big to fail.<sup>230</sup> Of course, identifying the firms the government regards as essential to the stability of the financial system does not reveal the circumstance of a rescue or the amount of protection that uninsured creditors will receive. It does, however, establish a floor under the identified institutions with respect to their debt issuances that sets them apart from their competitors.

A latter day variation of the Comptroller's list of eleven banks is the Fed's list of Large Complex Banking Organizations (LCBO).<sup>231</sup> Though not a public "list" *per se*, the LCBO program lends itself to rather precise estimates of the specific firms that are included.<sup>232</sup> According to the Fed, the LCBO program "is designed to recognize dramatic changes in the financial, technological, legal, and regulatory environment that necessitate a flexible supervisory framework."<sup>233</sup> Credit ratings agencies also get into the act of assessing those firms whose creditors are likely to receive government assistance.<sup>234</sup>

Despite all this messaging by official and nonofficial parties, the Fed showed in 1998 how easily it could be spooked by the possible failure of a firm that was on no one's TBTF list. Long Term Capital Management (LTCM) was a firm of only 200 employees but of immense leverage. The Fed-orchestrated rescue of LTCM demonstrated the fragility of the financial system and the arbitrariness of the Fed's systemic policy. So murky was the government's intervention posture *vis-à-vis* TBTF firms that even a wizened financial hand, Robert Rubin, was confused. As has been reported, Mr. Rubin urged a former Treasury colleague to intervene on behalf of the failing commodities firm and Citigroup customer, Enron, weeks before its demise.<sup>235</sup> His overture was rebuffed, but the temerity of its being made is indicative of the elasticity of the TBTF policy even at that time and even in the mind of one of the custodians of the policy.

The FDIC virtually acknowledges that the uninsured creditors of a large bank are likely to fare better in a resolution than are uninsured creditors of small banks. In a large bank resolution, the FDIC typically uses a bridge-bank to minimize possible spillover effects from the closure. Large bank systems, particularly the systems of banks that have undergone significant merger activity, are often incapable of sorting out insured

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<sup>230</sup> *Inquiry into the Continental Illinois Corp. and Continental National Bank: Hearing before the Subcomm. on Fin. Insts. Supervision, Regulation, and Ins. of the Comm. on Banking, Fin., and Urban Affairs*, 98th Cong. 18-19 (1984) (statement of Comptroller of the Currency Todd Conover).

<sup>231</sup> BD. OF GOVERNORS OF THE FED. RESERVE SYS., BANK HOLDING COMPANY SUPERVISION MANUAL § 2124.04 (2005) [hereinafter BHC Manual].

<sup>232</sup> Stern & Feldman, *supra* note 2, at 39.

<sup>233</sup> BHC Manual, *supra* note 231.

<sup>234</sup> Stern & Feldman, *supra* note 2, at 33.

<sup>235</sup> Mark Lewis, *Rubin Red-Faced Over Enron? Not in the Times*, FORBES.COM, Feb, 11, 2002, <http://www.forbes.com/2002/02/11/0211rubin.html>.

accounts from uninsured accounts, thus tempting the FDIC's invocation of its "systemic risk" powers to pay off uninsured depositors. As if to remove any of the ambiguity, the Treasury Department was quite open about the identities of the nine banks<sup>236</sup> that it invited to a meeting in Washington in the fall of 2008 and "asked" to accept capital infusions as part of the Capital Purchase Program.

Several of the reform proposals urge that, going forward, we not rely on the subtle and not-so-subtle messaging from regulators about which firms are and are not TBTF. The Group of Thirty, Brookings, and the Congressional Oversight Panel all call for the *identification* of TBTF firms up front. The criteria they would employ in the identification process is a combination of size, complexity, and interconnectedness. Perhaps the most extensive list of criteria comes from the Federal Reserve Board staff in connection with the LCBO program. According to the Fed, measures for inclusion in the LCBO program include:

- Total assets,
- Size of off-balance sheet exposures,
- Activity in derivatives markets,
- Trading assets and trading revenue,
- Foreign assets and foreign deposits,
- Funding from market (non-deposit) sources,
- Securities borrowed and lent,
- Income from fiduciary activity,
- Mutual fund sales and fee income,
- Revenue earned in mortgage markets,
- Assets under management,
- Activity in payments systems,
- Involvement in securities settlements,
- Geographic scope of operations, and
- Merchant banking activities and proprietary investments.<sup>237</sup>

In all likelihood, this list is not exhaustive particularly as it relates only to banks, and the new order of TBTF will cover nonbanks as well. The list is, however, illustrative of the capacity of regulators and others to evaluate

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<sup>236</sup> As the Treasury's action graphically illustrates, it is not just traditional financial intermediaries such as banks, insurance companies and investment banks that pose threats to the system. It includes institutions that provide the essential activities of payments, clearing, settlement and custody for the system such as Bank of New York Mellon and State Street Corporation. See GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 17 (2009) [hereinafter Group of Thirty Framework].

<sup>237</sup> Lisa M. DeFerrari & David E. Palmer, *Supervision of Large Complex Banking Organizations*, FED. RES. BULL., Feb. 2001, at 502.

firms based upon specific criteria and that evaluation can inform the judgment as to the risks those firms pose to themselves and to the system.

Both the evaluation process and the results it produces ought to be transparent. Defining the TBTF criteria for all to see will accomplish two objectives. First, it will guide the managements, of those firms that do *not* wish to be categorized as TBTF as to how to adjust the scope and scale of their firms to avoid the designation. Second, it will serve as a roadmap for the systemic regulator in identifying those firms whose operations, across the risk spectrum, pose substantial risks to the financial system and to the real economy. As discussed below, the consequences of this identification should be considerable, namely, the imposition of a rigorous regulatory regimen, and a pricing component.

### B. *Informing on TBTF Firms*

As the GAO Report points out, “A regulatory system should focus on risks to the financial system, not just institutions.”<sup>238</sup> Clearly, the correlation of risks across institutions and markets will be the task of the new systemic regulator. Nevertheless, it is widely recognized that the absence of a mandate placed on any of the financial institution regulators to monitor for systemic risk arising from the institutions they were charged with supervising contributed enormously to the current crisis. In the new order, therefore, it will be incumbent on the systemic regulator to oversee with intensity the firms it has identified as imposing systemic risk.

As Litan and Bailly have observed, there are two pillars to a stable financial system: market discipline and sound regulation.<sup>239</sup> During the Clinton and Bush administrations, excessive reliance was placed on market discipline at the expense of sound regulation.<sup>240</sup> In truth, both pillars, regulation and market discipline, need to be strengthened in recognition that both failed in the current crisis. Meanwhile, echoes of the *ancien regime* are still heard extolling the supremacy of market discipline over sound regulation.<sup>241</sup> These voices need to be discounted in light of current events.

For those few firms that will be defined as posing systemic risks, the bias of policy makers should be in the direction of sound regulation. Firms posing systemic risks are, by definition, threats not just to themselves, their shareholders, and their creditors, but to others as well. The socialization of those risks needs to be minimized beyond the capability of market forces. Also, the magnitude of the collateral damage to

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<sup>238</sup> GAO Framework, *supra* note 227, at 52.

<sup>239</sup> Litan and Bailly, *supra* note 23, at 7.

<sup>240</sup> *Id.* at 9.

<sup>241</sup> See generally Peter J. Wallison, *Regulation without Reason: The Group of Thirty Report*, FIN. SERV. OUTLOOK, Jan. 28, 2009. Mr. Wallison is a former general counsel of the Treasury Department.

the economy, arising from the meltdown of such firms warrants a firmer hand on their operations.

An era of profligate bailouts has released a genie that will be difficult to return to his lamp. Even before the events of 2008, a host of factors created a climate of moral hazard that encouraged excessive risk taking and systemic leverage on an unsustainable scale. One legacy of the casual bailout is the disruption of the normal flow of credit. Until such time as lenders and counterparties can extend credit without the distorting effects of a perceived government subsidy, it will be important for the systemic regulator to ingratiate itself with systemically significant firms.

The tools for this process are familiar, though many need to be enhanced in light of lessons learned from the current crisis:

- Capital requirements (modified to be counter-cyclical)
- Liquidity standards
- Activity restrictions
- Transparency
- Eliminating perverse compensation incentives
- Continuous monitoring by on-site examiners.<sup>242</sup>

To augment these traditional regulatory methods, other approaches have been suggested, such as scenario planning and enhanced Prompt Corrective Action (PCA).<sup>243</sup> Scenario planning refers to a process of examination by which regulators attempt to determine the spillover effect of one firm's failure on other institutions and the development of plans for addressing the failure of large banks.<sup>244</sup> In general, enhanced PCA contemplates utilizing the enforcement methodology of FDICIA that ratchets up the regulatory pressure on banks as their capital levels decline, but with the added measure that capital levels are determined on a more forward looking basis.<sup>245</sup>

Another suggestion for the regulation of TBTF firms is requiring them to issue a percentage of assets in the form of long-term, subordinated debt instruments possibly convertible into equity.<sup>246</sup> In theory, the market discipline of debt holders who do not benefit from enhanced earnings of the firms, whose long-term debt they hold, will temper the risk appetite of TBTF firms. Similarly, the pricing of such debt in the market could serve as an additional gauge for the regulator as to the health of the TBTF firm.

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<sup>242</sup> As recommended by the Group of Thirty and the Brookings Institute. See Group of Thirty Framework, *supra* note 236, at 12; see LITAN AND BAILY, *supra* note 23, at 11. Capital requirements can be made counter-cyclical by requiring regulated firms to augment capital during periods of relative stability.

<sup>243</sup> See Stern & Feldman, *supra* note 2, at 7, 10.

<sup>244</sup> *Id.*

<sup>245</sup> *Id.* at 10, 11.

<sup>246</sup> Litan and Baily, *supra* note 23, at 11.

The Financial Stability Forum<sup>247</sup> has recommended the establishment of a “college of supervisors” for each of the largest global financial institutions.<sup>248</sup> Although the composition and the mandate of these colleges have yet to be determined,<sup>249</sup> the concept of having a team focused on firm-wide risk management and cross-border liquidity is valid. For TBTF firms that are global in their reach, as most will be, international supervisory information sharing and cooperation will be essential.

Another possibility is the establishment of “public interest” directorships on the boards of directors of TBTF firms. The author has argued for some time that, in exchange for their substantial equity infusions, taxpayers deserve board representation to oversee their considerable investments in large banks.<sup>250</sup> The notion of public interest directors is a well developed one as, for example, each of the twelve Federal Home Loan Banks is required to have several such directors. Like other so-called “constituency” directors, the role of the public interest directors would be to represent both the shareholders and the taxpayers.

The regulator of the TBTF firm has a different mandate than does a prudential regulator. The systemic regulator must: first, minimize the possibility of a TBTF firm imploding; and, second, establish procedures and standards that will minimize the spillover effect from a TBTF firm’s failure. To accomplish the first goal, a combination of traditional and innovative regulatory methods, as described above, should be applied to TBTF firms. Success in accomplishing the second goal of reducing spillover effects from TBTF events will, in time, reduce the number of TBTF firms.

### C. Pricing

Finally, we now come to the essential and the defining point of the way forward in financial regulation. As observed, many of the reports and studies agree on the dual notions of identifying TBTF firms and regulating them with intensity. What they have avoided is the essential component: recapturing for the taxpayer the financial benefit taxpayers confer on TBTF

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<sup>247</sup> The Financial Stability Forum, housed and supported by the Bank for International Settlements, Basel, Switzerland, brings together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank, to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance.

<sup>248</sup> FINANCIAL STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 4 (Apr. 7, 2008).

<sup>249</sup> *Id.* at 42.

<sup>250</sup> Cornelius Hurley, *We Have Equity, Now Give us Oversight*, AM. BANKER, Oct. 28, 2008, at 10.

firms in the form of an implicit guarantee of the firms' debt. Without this pricing adjustment, the moral hazard genie is free to do more damage.

The TARP Congressional Oversight Panel's majority report<sup>251</sup> regrettably muddies the waters on this issue; however, the minority<sup>252</sup> report manages to put it back in focus. Under its list of "Critical Problems" in need of resolution, the majority, with seeming boldness, titles its first recommendation "Identify and Regulate Financial Institutions that Pose Systemic Risk."<sup>253</sup> In its narrative, however, the majority pulls its punch by saying what it really meant by identifying institutions was to "...identify the degree of systemic risk posed by financial institutions, products, and markets..."<sup>254</sup> This is a far cry from identifying specific institutions. The minority, however, responds with considerable clarity by frontally addressing the issue of pricing for TBTF identified firms:

In the alternative case, the market may view designation [as TBTF] as a *de facto* guarantee of public support in [sic] during times of financial stress. The firm attains a beneficial market status, and enjoys advantages such as a lower cost of capital in the public markets. The costs of failure are thus socialized, while profits remain in private hands (much as was the case for the GSEs, Fannie Mae and Freddie Mac). Recent events make clear that this scenario is perhaps an even more undesirable outcome than the former.<sup>255</sup>

As the minority correctly points out, we need to learn from the failed Fannie/Freddie business model of socializing risk and privatizing reward. Regrettably, the events of 2008 have extended that business model to Citigroup, Bank of America, AIG, etc., at least with respect to their uninsured creditors. Charging TBTF firms for the value of their funding subsidy would compensate the taxpayer and ensure that the risk of TBTF firms is not socialized. Call the charge a premium, a tax, or a surcharge as you will; it will, in every instance, dissuade firms from the headlong pursuit of the TBTF business model. This rather modest public policy action will restore equilibrium to our financial market by removing the distortive effects of the implicit federal subsidy of large and complex firms. Combined with the intense regulation of TBTF firms, this regimen will minimize, but not eliminate, the possibility of firm failure.

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<sup>251</sup> Congressional Oversight Panel *supra* note 22, at 22.

<sup>252</sup> Minority members of the Panel are Cong. Jeb Hensarling and former Sen. John E. Sununu.

<sup>253</sup> Congressional Oversight Panel, *supra* note 22, at 22.

<sup>254</sup> *Id.*

<sup>255</sup> *Id.* at 87.

And what is the price that TBTF firms pay for their status? Quite simply, it is the *delta* between the funding costs of non-TBTF firms and those of TBTFs. Once more, the GSE experience should be instructive.

## VIII. CONCLUSION

An inherent tension of our system of prudential regulation is the tolerance for risk and bank failure. For all the obeisance to safety and soundness as a guiding principle of bank regulation, it is recognized that some banks will and should fail. It is axiomatic that a system so restrictive as to eliminate the risk of failure would also stifle the risk of innovation. It is also well settled that the losses arising from a bank's failure should be borne by its stakeholders, and not by innocent third parties, or by the financial system in general.

The TBTF firm presents the compelling case where failure cannot occur without losses being imposed system-wide on stakeholders and on non-stakeholders. Like the poor, we will always have TBTF firms with us. The symbiotic relationship between TBTF firms and the financial system needs to be recognized, and the price advantage that accrues to such firms as a result of the public subsidy needs to be recouped. Doing so will, among other things, retard the pursuit of corporate gigantism that has characterized the last three decades of free market exuberance and encourage more competitive markets.

